May 28, 2008

Currencies

**VND: Beyond the Tipping Point**

**Key takeaway:** The VND is now beyond the tipping point, in our view – a point beyond which its price and underlying fundamentals cannot recover. Yesterday, the VND forward markets gapped suddenly to price in a full-scale devaluation episode for the VND. We are not surprised. The economy has been flashing many of the classic warning signs for a potential devaluation episode for some time. But it has only been the latest data updates on trade and inflation that finally triggered a stepwise re-pricing of the VND’s downside risks in the market. With a devaluation episode now discounted ahead, the issues now are: 1) how long can the Vietnamese authorities hold out?; 2) what is the likely size of the devaluation?; and 3) what are the contagion risks for the rest of the region?

**Price update:** There is a run on the VND currency. The USD/VND’s NDF market gapped yesterday, with the 12m outright jumping 11% to VND20,700 and gapped further today to VND22,250. This implies that the market is now anticipating a VND devaluation of 38% against the USD (from current spot levels) over the next 12 months. When prices shift this much in emerging markets, it is rare that they recover – the market psychology changes irrevocably, in our opinion. We are not surprised. At the beginning of the year, we broke the VND off our fundamental ‘Wedding Cake’ rankings because Vietnam was flashing many of the classic warning signs of a potential devaluation episode ahead (see “AXJ: Wedding Cake 2.0”, *FX Pulse*, January 3, 2008; “VND: Demoted”, *FX Pulse*, January 10, 2008; *VND: Risk/Reward Deteriorates*, April 15, 2008 and *VND: Rate Hike Will Not Be Enough to Stabilize the VND*, May 19, 2008).

**Wrong-footed:** That said, we have not got the VND call completely right this year. We advised that the tactical, short-term USD/VND trading window had opened up in January (see *VND: Policy Surprise*, January 31, 2008 and with exit conditions outlined in *VND: Risk/Reward Deteriorates*, April 15, 2008). We were overly enamored by the fact that the SBV’s...
Policy tightening and the apparent end to its crawling-peg VND policy opened up a short-term trading opportunity. But as it transpires the trade was swamped by the medium-term risks that we have been warning of all along.

Exhibit 1
USD/VND: 12m NDF

Macro instability and currency misalignment: One thing we have been consistently correct on is Vietnam’s medium-term risks. We believe that the VND is heading towards a standard, late-cycle ‘currency crisis’, in our view. Certainly, many of the classic fundamental conditions for such an episode seem to be in place, namely an overvalued exchange rate, a dangerously unbalanced economy and low FX reserves. VND’s real effective exchange rate (REER) is overvalued, but the overvaluation is not extreme – only 1.3sd over its long-term average. This underscores our view that VND’s key vulnerability is not a ‘valuation’ misalignment, but a severe macro imbalance. Vietnam’s economy is unstable because its current account deficit is 5% of GDP and is expected to widen to 7.5% in 2008 (according to the SBV). This is unsustainably large, in our opinion. This is best demonstrated by the fact that FDI (a source of sustainable deficit financing) is expected by the SBV to drop to 32% of total external financing in 2008 (from 70% in 2007), the rest being made up by ‘hot money’.

Late-cycle growth risks: On the internal side of the macro balance, conditions are weakening. GDP growth momentum is fading as policy is tightened aggressively (e.g., policy rates were hiked 325bp to 12% on May 19, 2008), and the global economy turns. The Vietnamese authorities have already revised down their growth forecast twice this year to 7% (trend) from 8.5%. Any further growth deceleration below 7% would indicate to us that Vietnam’s macro dynamic has turned outright negative for the VND.

Exhibit 2
Vietnam: REER

Running on low reserves: At the same time, Vietnam’s FX reserves are low. Unfortunately, Vietnam’s reserve data are dated. The latest official release we have is US$21.7 billion for July 2007. Total imports for 2007 were US$60.8 billion. Monthly import cover was therefore approximately 3.9x last year. That said, we think this underestimates current FX reserves as they had been on a rising trend in recent years (US$13.6 billion in 2006). We imagine that the trend persisted all the way through 2007 (given the heavy FX intervention that the SBV had to do to offset the large capital inflows into Vietnam last year). We therefore think that FX reserves could have accumulated by an extra US$5 billion last year (US$ 27 billion), which could take the import cover up to 4.9x. But even with this adjusted figure, we think FX reserves may still be too low. For us, the minimum margin of safety to sustain external financing is for import cover to be around 6-9x. It therefore seems to us that the SBV does not have the adequate financing to withstand a sustained run on its currency.
Complications for the currency adjustment process:
Adding to the fundamental mix is Vietnam’s extended banking system and rampant inflation – factors that will complicate the currency adjustment process. Data on Vietnam’s banking system are limited, but we believe the financial system has overreached itself. Loan growth has been running above 35%Y – a rate that is not consistent with prudent lending practices, in our view. Exposure to the property market has been large, by emerging market standards, at 10% of total loans. As the economy turns, non-performing loans are likely to increase, especially the property loans, given that Vietnam’s property boom has already ended. The *Saigon Times Daily* reported on May 26 that apartment prices in Ho Chi Minh City have declined 50% since January. There is therefore an increasing risk that a systemic banking crisis could exacerbate the currency crisis. At the same time inflation (25.2%Y) is spiraling out of control. This indicates that the VND’s internal value (i.e., its purchasing power) as well as its external value (i.e., its exchange rate) are simultaneously being eroded. In situations like this, it is usual to observe that the two values feed off each other, with higher inflation increasing after a devaluation event, which then fuels further depreciation.

The market trigger: The economic data updates on inflation and trade in the past week were the actual touchstones for the stepwise re-pricing of the VND’s downside risks. The external deficit widened dramatically to US$14.4 billion (with imports up 67%YTD) and inflation jumped to 25.2%Y from 21.4%Y in April. All this, it seems, was too much for the market to ignore, leading to a complete reassessment of macro balance and inflation risks at hand. The only issues that remain are: 1) how long can the Vietnamese authorities hold out?; 2) what is the likely size of the devaluation?; and 3) what are the contagion risks for the rest of the region?

1. How long can the Vietnamese authorities hold out?
Timing when crises actually break is enormously difficult. On paper, the SBV could technically hold off a speculative attack for some while. As mentioned above, FX reserves are low. But the central bank has access to part of the US$80 billion swap line set up by ASEAN and its three main dialogue partners (Japan, Korea and China) for such crisis events. The maximum amount that the SBV can tap is US$58 billion (i.e., 72% of the total line), which could bolster FX reserves by an extra 11x import cover. At the same time, the SBV could further raise policy rates aggressively. As described above, we have seen that the SBV has the capacity to tighten policy aggressively. Moreover, Vietnam’s macro dynamic has yet to turn outright negative. However, we are concerned about two issues that may induce an early crisis. First is the policy rhetoric. So far, the Vietnamese authorities do not seem to be verbally intervening heavily enough, given the seriousness of the situation. Second is that market price momentum is taking hold, which once started, is often very hard to stop.

2. What is the likely size of the devaluation?
In some ways, Vietnam’s fundamental situation is comparable to that of Thailand’s in 1997. Just prior to the THB devaluation, Thailand’s external deficit was 6.5% of GDP, which led to a 55% decline in the currency. Given Vietnam’s approximately similar deficit size (and the additional complicating factors of the banking system and inflation), the VND could face similar downside risks, in our view.
3. What are the contagion risks for the rest of the region? A devaluation episode could trigger a contagion throughout the region, in our view. We think the contagion will not travel so much via trade links, but through the market, targeting similar macro-weakening, inflation-prone currencies in the region. Given this metric, the INR is perhaps the most vulnerable.

Bottom Line

The markets are pricing a devaluation episode as Vietnam’s fundamental risks are repriced. The SBV has the potential to maintain external financing for a while, although we are mindful of SBV’s commitment and market momentum. If the devaluation episode does occur, we think it is likely to be large, with potential contagion risks spreading to other fundamentally weak countries in the region.
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